United States Court of Appeals

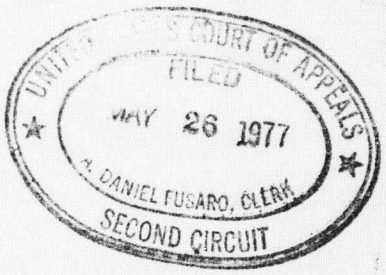
for the Second Circuit

PETITION FOR REHEARING

76-5020

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT



In the Matter

of

F. O. BAROFF COMPANY, INC.,

Debtor.

BPIS

AMERICAN BANK & TRUST COMPANY,

Plaintiff-Appellant,

-against-

EDWARD S. DAVIS, TRUSTEE,

Defendant-Appellee.

PETITION FOR REHEARING

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James W. Giddens
Philip H. Curtis
Ronald J. Tabak
Of Counsel

May 26, 1977

TABLE OF CONTENTS

TABLE OF AUTHORITIES

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 122 - SEPTEMBER TERM, 1976

Docket No. 76-5020

- x

In the Matter :

of :

F. O. BAROFF COMPANY, INC., :

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- x

AMERICAN BANK & TRUST COMPANY, :

Plaintiff-Appellant, :

-against- :

EDWARD S. DAVIS, TRUSTEE, :

Defendant-Appellee. :

- x

PETITION FOR REHEARING

Defendant-appellee Edward S. Davis, Trustee, petitions for rehearing pursuant to Fed. R. App. P. 40 the decision and judgment of this Court (Friendly, Hays and Mulligan, J.J.) which holds that, under New York Insurance Law § 167(1)(a), despite the fact that a bankrupt insured has suffered a loss covered by its indemnity insurance by paying injured third parties, the insured's right to the policy proceeds is inferior to the right of such third parties to recover on the unsatisfied portion of their claims.

REASONS FOR GRANTING REHEARING

The Court's decision overlooks an issue of importance under the Federal Bankruptcy Act. Thus, under the Court's construction of the New York law it gives the plaintiff-appellant a statutory lien which becomes effective upon the insolvency of the debtor. However, such statutory liens are invalid against the trustee, under Bankruptcy Act § 67c(1)(A), 11 U.S.C. § 107(c)(1)(A). Since a state law must not conflict with the Bankruptcy Act, the New York law is clearly preempted if the Court's construction is correct. The only way to avoid preemption is to construe the statute such that it does not create a statutory lien. Such a construction would also eliminate the inequity and internal inconsistency of the Court's decision, which takes into account only some, not all, payments by the insured to the injured person.

I. UNDER THE COURT'S HOLDING, THE NEW YORK INSURANCE LAW, AS APPLIED HERE, CREATES A STATUTORY LIEN ON INSOLVENCY, WHICH IS INVALID UNDER THE BANKRUPTCY ACT

The Court holds that under section 167 of the New York Insurance Law, a third party with an unsatisfied claim covered by a bankrupt insured's indemnity receives a right to the proceeds of the insured's indemnity upon the insured's insolvency. The Court also holds that this right is superior to the right of the insured's trustee, even though the proceeds involved are reimbursements to the bankrupt for payments made to the third party in partial satisfaction of its claim. Here,

this holding entitles the third party to take $79,321.62 of the insurance proceeds, despite the fact that those proceeds were paid to reimburse the insured for the loss it incurred by releasing to the third party $79,321.62 in escrowed proceeds of collateral.

However, the superior right to insurance proceeds, which the third party receives under the Court's view of the statute, constitutes a "statutory lien" which is invalid against the insured's trustee. Section 67c(1)(A) of the Bankruptcy Act, which governs such liens, states:

> "(c)(1) The following liens shall be invalid against the trustee:
>
> > "(A) every statutory lien which first becomes effective upon the insolvency of the debtor, or upon distribution or liquidation of his property. * * *." (11 U.S.C. § 107(c)(1)(A).)

Section 67c(1)(A) clearly applies here to the superior right to insurance proceeds which the third party is given under the Court's construction of the New York insurance statute. This right is a "statutory lien", under the pertinent definition:

> "* * * a lien arising solely by force of statute upon specified circumstances or conditions * * *." (11 U.S.C. § 1(29a).)

The right obviously arises "solely by force of statute upon specified circumstances or conditions." And, the Court's opinion demonstrates that this statutory right is a "lien" when it states that the statute creates "in effect a trust

fund for the benefit of the injured person." Slip Opinion at 3487.

Moreover, this "statutory lien" certainly "first becomes effective upon the insolvency of the debtor, or upon distribution or liquidation of his property." As stated in the passage which the Court quotes (at page 3488) from Merchants Mutual Automobile Liability Insurance Co. v. Smart, 267 U.S. 126 (1925)*:

> "[T]he clause becomes operative only in the event of the insolvency or bankruptcy of the assured." (267 U.S. at 131.)

Consequently, the third party's statutory right to the insurance proceeds is invalid as against the trustee under the Bankruptcy Act, which preempts statutes that create security interests which become effective upon a debtor's insolvency or bankruptcy. Here, the statute as construed would put the third party and others similarly situated in the position of secured creditors.

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* At the time of the Merchants Mutual decision, statutory liens were not invalidated by the Bankruptcy Act. Indeed, until the passage of the Chandler Act in 1938, state priorities were generally recognized in bankruptcy proceedings. See S. Rep. No. 1159, 89th Cong., 2d Sess. (1966), U.S. Code Cong. Admin. News 1966, pp. 2456-57.

But in this situation that is contrary to the very purpose of Bankruptcy Act § 67c(1)(A), whose drafters stated:

> "[I]f a class of creditors could obtain State legislation transforming their debts into liens, they would then be in a position superior not only to all other general creditors but to priority claimants as well. This would be the result not only in the case of liens creating a non-contingent property interest in a specific asset but also in the case of liens which become effective only in the event of insolvency * * * [T]he effect of their recognition in bankruptcy would be to distort the federally ordered scheme of distribution by depressing the position of [minority] claimants." (S.Rep.No. 1159, 89th Cong., 2d Sess. (1966), U.S. Code Cong. Admin. News 1966, p. 2456.)

Consequently, if the Court's construction of the New York Insurance Law is correct, then the right which the third party has to the insurance proceeds is invalidated by the federal Bankruptcy Act. Under principles of federal preemption, the federal Bankruptcy Act controls whenever it conflicts with a state statute, because Congress has exercised its power under Article I, Section 8, Clause 4 of the Constitution to establish uniformity with respect to bankruptcies. See International Shoe Co. v. Pinkus, 278 U.S. 261 (1929).

The Court can avoid this preemption, however, by construing the state statute so that it does not deny the trustee's superior right to proceeds of the debtor's insurance recovered in reimbursement for losses suffered by the debtor.

II. THE COURT'S DECISION IS INCONSISTENT AND INEQUITABLE

The Court should, in any event, permit rehearing because its decision is fatally inconsistent and inequitable. Thus, on the very same page on which the Court states that the plaintiff's right to the policy proceeds is "qualified to the extent that Baroff also made payments to Mrs. Corey, the person it injured," the Court also says that "in determining rights to policy proceeds as between such an injured person and his injurer, payments by the insured to the injured person are not to be taken into account." Slip Opinion at 3493 & n.8.

The defendant submits that the first statement is correct. The $79,321.62 paid to the Bank was a payment to the injured person since that sum was released to the Bank only because the Bank had become the subrogee of the injured person. A contrary ruling inequitably permits the Bank to recover the $79,321.62 for a second time.

CONCLUSION

For the reasons stated above, rehearing should be granted.

May 26, 1977

Respectfully submitted,

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Of Counsel

STATE OF NEW YORK)
: ss.:
COUNTY OF NEW YORK)

AFFIDAVIT
OF SERVICE

John J. Sullivan, being duly sworn, deposes and says that he resides at 515 West 59th Street, New York, New York 10019

; that on the 26th day of May, 1977, he served the within Petition for Rehearing

on the attorneys for Federal Deposit Insurance Corporation, as Receiver for Plaintiff-Appellant American Bank & Trust Company herein by mailing ~~to~~ true copies thereof, securely enclosed in a post-paid, properly addressed wrapper, in the mail box under the exclusive care and custody of the United States Postal Service at the corner of Wall Street and Broadway, New York, New York, addressed to said attorneys as follows:

Kaye, Scholer, Fierman
Hays & Handler
425 Park Avenue
New York, New York 10022

The above address has appeared on the prior papers in this action as the office address of said attorneys.

Deponent is over the age of 18 years and not a party to this action.

John J. Sullivan

Sworn to before me this
26th day of May, 1977.

Howard F. Hart
Notary Public

HOWARD F. HART
Notary Public, State of New York
No. 31-4511201
Qualified in New York County
Commission Expires March 30, 1979